Bulgaria and the Copenhagen Economic Criteria for EU Membership

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Introduction

The present report analyses the progress made by Bulgaria in meeting the Copenhagen economic criteria in the period following the latest 2001 Regular Report of the European Commission. There are three accents placed in the report:

- Bulgaria's progress in meeting the Copenhagen economic criteria for the 2001-2002 period.
- The report draws some comparisons of key economic indicators for the 10 transition economies, candidates for EU membership.
- Where possible, a review has also been conducted of the progress registered in the 1998-2001 period, i.e. in the years following the introduction of the currency board in Bulgaria. The review provides information about Bulgaria's track record on meeting some of the Copenhagen sub-criteria

The choice of the 1998-2001 period is not accidental. This is the period following the introduction of the currency board in Bulgaria, which marks the transition to a new type of a monetary system and represents a turning point in Bulgaria's transition to a market economy. The inclusion in the analysis of the years, preceding the currency board, would be incorrect since that would lead to a mix-up of different monetary systems and, hence, different types of economic policies. The introduction of the currency board marks a turning point in the implementation of the structural reform in Bulgaria and the inclusion in the analysis of the 6-month period preceding the currency board introduction would mean a mix-up of radically different periods in the restructuring of the Bulgarian economy. That would distort, to a great extent, the perception of Bulgaria's progress made both in terms of macro-economic stability and structural reform implementation.

The present report also contains certain comparisons of key economic indicators of the 10 transition economies, candidates for EU membership. They give a clearer and more objective idea of Bulgaria's relative progress or lagging behind in the process of its accession to the EU. These comparisons have been suggested by the Strategy Paper and Report by the European Commission on the Progress towards Accession by each of the Candidate Countries prepared each year in parallel to the individual Regular Reports on the EU membership candidates.

The present report is based on data provided by the official national institutions. At the same time, in an effort to avoid any subjectivity in our assessment, we have tried, to a maximal degree, to reflect the assessments made by a number of international institutions such as the International Monetary Fund (IMF), the World Bank (WB) and the European Bank for Reconstruction and Development (EBRD).

1. Macroeconomic indicators and trends

The real sector

The Bulgarian economy continued its upward trend of development in 2001 in a stable domestic macroeconomic environment despite adverse external shocks/developments? The gross domestic product (GDP) rose by 4% in 2001, marking a fourth consecutive year of relatively high growth compared to the average figures for EU member and candidate countries (Table 1). The growth rate slowdown (compared to the record high 5.4 % in 2000) was partly due to the lower external demand by the EU and Turkey as well as the global economic slowdown, which affected mainly the demand for key Bulgarian exports such as metals and chemical products. At the same time, the private sector continued to expand its role proving that the process of liberalization had reached levels typical of functioning market economies. The private sector reached 72% of the gross value added and surpassed the shares of many EU member states. The 7.3% private sector growth in 2001 was the major factor for offsetting the negative external shocks and contributing for substantial growth in production of consumer goods and tourist services, the latter guaranteeing the positive structural transformation of the Bulgarian economy towards more competitive sectors with higher rates of value added. Gross fixed investment marked a rapid increase at the rate of 20% in 2001 thus reaching 18% of the GDP.

Alongside economic growth, unemployment, one of the key negative economic indicators for Bulgaria, has also registered some improvement. The unemployment rate went down by almost 1 p.p. in the period between April 2001 and April 2002. However, this tendency is still weak and the unemployment rate remains high due to the intensive structural changes in the economy.

The comparative analysis of the 2001 economic growth indicators in the EU membership candidates shows a generally positive development of Bulgaria (See Table 1). In 1998-2001 Bulgaria registered a higher-than-average for the EU candidates GDP growth and reached substantially higher growth rates as compared to countries like Lithuania and Slovakia and especially in comparison to Romania, all of which were invited for accession negotiations at Helsinki. Because of the open nature of the Bulgarian economy the 2001 economic growth was affected more adversely by the economic slow- down in Bulgaria's key foreign partners without causing a reversal in the trend towards a stable economic growth that has been witnessed for a number of consecutive years.

In end-year consumer price inflation remained relatively low at 4.8% in 2001, while the producer price inflation was 0.7%. The January-April 2002 period recorded a considerable consumer-price rise of 5.1%, but the change was caused by a one-time adjustment of administered prices, increased excise duties, removed VAT exemptions and the price increase in imported oil. Most of these factors have a one-time effect, which becomes evident from the following steep deflation rates in AprilJune. They do not pose a threat to the price stability and revised expectations suggest of about 7% end-year inflation in 2002.

The 6.2 % average annual inflation for the period following the introduction of the Currency Board in Bulgaria is substantially below the average for the EU candidates (9.5%) and is far lower than the inflation in countries like Romania and Slovakia (See Table 1). The same conclusions could be drawn for 2001. Countries having adopted currency boards/ fixed currency exchange rates (Bulgaria, Estonia, Latvia and Lithuania) have scored the lowest inflation results, whereas inflation continues to pose a serious problem to Romania.

Table 1 Key Economic Indicators*

Percent

Country	GDP		Investment		Inflation		Budget deficit/ GDP		Unemployment	
	1998-2001	2001	1998-2001	2001	1998-2001	2001	1998-2001	2001	1998-2001	2001
Bulgaria	**3.9**	**4.0**	**16.5**	**16.0**	**6.2**	**4.8**	**-0.5**	**-0.9**	**15.8**	**17.3**
Estonia	4.2	5.4	4.0	17.2	4.9	4.3	-1.3	0.4	12.2	12.7
Latvia	4.8	7.6	15.5	11.0	2.7	3.0	-2.5	-1.8	13.5	13.1
Lithuania	2.7	5.7	2.6	10.6	1.5	2.0	-4.7	-1.7	15.0	17.0
Poland	3.5	1.1	3.4	-10.2	7.6	3.6	-4.0	-6.0	14.0	17.3
Romania	-0.4	5.3	-2.8	6.6	41.6	30.2	-3.9	-3.5	10.3	8.6
SLovakia	2.9	3.3	0.8	11.6	8.7	6.5	-4.0	-3.9	18.1	19.8
Slovenia	4.2	3.0	7.2	-1.9	7.6	7.0	-1.2	-1.2	7.0	5.9
Hungary	4.5	3.8	7.5	3.1	9.6	6.8	-3.7	-3.3	9.4	8.4
Czech Republic	1.0	3.6	1.7	7.0	4.4	4.1	-4.0	-5.7	8.7	8.9
Average	**3.1**	**4.3**	**5.6**	**7.1**	**9.5**	**7.2**	**-3.0**	**-2.8**	**12.4**	**12.9**

Source: *EBRD Transition report, update 2002; European Commission, European Economy, Enlargement Papers, April 2002.*

**Data for 1998-2001 represent an average annual change or value for the period. Inflation and unemployment indicators reflect end-of-year values.*

Budget

The fiscal policy continued to be an important stabilizing factor in 2001-2002. For a fourth year in a row, the budget over-performed the planned indicators despite the overall tax burden reduction. The 2001 budget deficit was reduced to 0.9%, down from the initially planned 1.5% of GDP as a way to limit the adverse external shocks on the country's trade deficit. Revenues exceeded the budget projections by 1%. The positive trends in the budget sector continued in 2002. A surplus of euro 46 million was reported for the January-April period against the background of another tax burden reduction. The quantitative fiscal criteria for the first three months, as laid down in the IMF agreement, were over-fulfilled. Continuity has been the basic merit of the fiscal policy since the change of the government in Bulgaria, guaranteed by the conclusion of a new stand-by agreement with the IMF. The low budget deficit and overall tax reduction targets were preserved, amid a shift from direct income taxes to the indirect taxes, decentralization of local taxes and duties, tax unification and simplification. Almost all VAT exemptions have been eliminated.

The government worked out a medium-term program for 2003-2005 aimed at guaranteeing continuity and predictability of the future fiscal policy. Improvements continued to be registered in the transparency and predictability of the tax policy following its presentation for discussion and the subsequent approval by the IMF of the basic 2003 fiscal parameters and the 2003--2005 tax policy. The parameters laid down in the program envisage a budget deficit reduction from 0.8% of GDP in 2002 down to 0.5% in 2003. The tax burden is expected to go down by 1 p.p. of GDP with the aim to limit the redistribution role of the state. A progressive lowering of the rates of both corporate tax and personal income tax is envisaged until 2005, the revenues being partially compensated with higher excises. The neutrality of the tax system with regard to sector policies will be preserved. The low deficit and the limited redistributive role of the budget are important evidence for the existence of a free market and place the country in a favorable position vis-à-vis the EU fiscal parameters. In early June 2002, the government adopted a Concept and Program for Fiscal Decentralization, which aims to provide financial autonomy to the municipalities. The program envisages a constitutional amendment and the passage of a system of new laws designed to increase the independence of municipalities in setting local tax and duty rates. That would help municipalities devise and implement autonomous policies taking account of specific regional priorities.

The country comparisons of the budget deficit-to-GDP indicators for the EU membership candidates show that in average terms for 1998-2001, Bulgaria maintains the lowest budget deficit. It is far lower not only in comparison to the countries from the Helsinki group but also in all EU membership candidates. The latter comes as a proof of the consistently maintained fiscal discipline, which is a serious condition for macroeconomic stability (Table 1)

External sector

In 2001 the current account deficit rose to 6.5 % of GDP but the net inflows in the capital and financial accounts secured a large balance-of-payments surplus. The tourist industry reaffirmed its position of an important current-account factor with USD 1.2 billion of revenues, recording a 12 % increase on the previous year. Tourist industry current-account revenues reached 24% of the overall export-of-goods revenues and offset to a large extent the external shocks on the trade deficit stemming from lower prices of basic Bulgarian exports. The expected double-digit growth in the tourist industry and the long-term trend towards an increase in investment following the penetration in the sector by big international tour operators represent a guarantee for a long-term sustainability of the current account.

In the first three months of 2002, the current-account deficit remained, in absolute terms, at the previous year's level recording a relatively weak drop from 1.7% down to 1.6 % of GDP. IMF estimates suggest that fuel prices and the slow-down in the EU economic growth are the key risk factors in the external sector. These factors could widen the current-account deficit from the expected 5.9% up to 7% of the GDP. Even in that case the deficit would not be able to threaten the balance of payments in view of the expected level of foreign direct investment and EU pre-accession funds. On the other hand, the foreign debt restructuring following the exchange of USD 1.3 billion Brady bonds for Eurobonds will decrease the debt principal repayments in the financial account at an annual rate of about 0.5% of GDP for the period up to 2012, with the key benefits to be registered by 2005.

Under the currency board, the stability of the Bulgarian economy could be challenged by a current-account deficit in case the latter is not fully compensated by foreign investment inflow or other non-debt financing and in case the government does not systematically conduct a low-budget deficit policy (Tables 1 and 2). In comparative terms for the 1998-2001 period, Bulgaria recorded a substantially lower than the average current-account deficit for all EU membership candidates and in 2001 the country registered a deficit comparable to that of Estonia and far lower than the figures for Latvia and Slovakia. The 1998-2001 data for foreign direct investment as percentage of GDP in Bulgaria are far above the EU candidates' average, with only the Czech Republic and Estonia being able to show better performance than Bulgaria. As to the budget deficit, Bulgaria recorded the lowest deficit-to-GDP ratio for the 1998-2001 period. Estonia is the only country to outrun Bulgaria in 2001 (Tables 1 and 2). These indicators prove that not only in 2001 but throughout the entire period following the currency board introduction, Bulgaria has been in a position to guarantee the necessary conditions for macroeconomic stability.

Table 2 External Sector Indicators

Percent of GDP

Country	Current Account Deficit		Gross Foreign Debt		Net Foreign Direct Investment	
	1998-2001	2001	1998-2001	2001	1998-2001	2001
Bulgaria	**-4.6**	**-6.5**	**82.1**	**75.7**	**6.0**	**4.9**
Estonia	-6.7	-6.5	58.0	60.9	7.1	6.4
Latvia	-9.4	-10.0	61.3	70.9	4.5	2.6
Lithuania	-8.8	-5.8	41.1	43.8	5.0	3.8
Poland	-5.5	-3.9	40.4	38.9	4.0	3.6
Romania	-5.1	-6.1	27.2	30.5	3.4	3.0
Slovakia	-7.0	-8.9	55.6	56.9	5.9	7.4
Slovenia	-2.1	-0.4	30.5	35.7	1.2	2.0
Hungary	-3.6	-2.3	62.8	69.0	3.4	4.3
Czech Republic	-3.6	-4.7	41.1	39.0	8.8	8.5
Average Value	**-5.6**	**-5.5**	**50.0**	**52.1**	**4.9**	**4.7**

Source: *EBRD Transition report, update 2002.*
**Data for 1998-2001 represent an annual average for the period.*

As a result of the positive balance of payments position, the economic growth and the USD 200 million external debt buy-back in 2000 (booked in 2001), the public debt dropped from 81% of GDP at the end of 2000 down to 74% at end-2001 to 61.3% at the end of June 2002. At the same time, the average maturity of both domestic and external debt increased and long-term debt interest rates went down, and the spread between yields on short-term and long-term debt was reduced. Bulgaria's short-term debt indicators are among the most favorable among those for the EU membership candidates.

The consistent economic growth, sustainable economic current account and fiscal balance and substantial debt reductions led to a rise in the country's credit rating in late 2001. The top three credit rating agencies - Standard&Poor's, Fitch and Moody's - upgraded Bulgaria's long-term credit rating by one notch. The large investment banks reacted positively, as the bids for the debut Eurobond issue of the Bulgarian government and the debt swap bids exceeded the supply, thus reaching yields lower than the average for countries with the same credit rating. Bulgaria received also the unconditional support of the international financial institutions. The IMF approved a new two-year stand-by agreement of SDR 240 mln. The World Bank adopted a three-year Country Assistance Strategy, providing up to USD 750 million under its baseline scenario. The European Bank for Reconstruction and Development (EBRD) announced an ambitious USD 500 million program providing funding for private sector projects until 2004.

2. Structural reform

Privatization

The small and medium enterprise privatization was almost completed by the end of 2000 with only about 15 % of the assets earmarked for privatization remaining state-owned. The tourist industry privatization continued through 2001 and early 2002 when almost all hotels in *Slanchev Bryag (Sunny Beach)*, the country’s second largest tourist resort, were transferred into private hands. At the end of May 2002, Bank Austria was selected to be the exclusive buyer of the Bulgarian Biochim Bank. A number of mines were sold as well as autonomous parts of defense industrial companies and water power plants thus bringing the share of state ownership in medium and small enterprises down to below 10%. All of the enterprises in the latter category are included in the list of 1,700 enterprises slated for privatization in 2002. However, their economic weight is almost negligible. The efforts of the government are already directed towards the privatization of the natural monopolies. The sell-off procedures for the BTK telecommunications company and the Bulgartabac tobacco holding are at an advanced stage. By the end of the year both BTK and Bulgartabac are expected to be privatized. *Bulgarski Morski Flot (Bulgarian Merchant Navy)* whose assets place it among the ten biggest enterprises in this country, is also included in the list of those earmarked for privatization. Seven electricity redistribution companies have been transformed into autonomous units, which will be privatized with the technical assistance provided by the EBRD. With the financial aid of the EU, a bidding procedure was launched in March 2002 for selection of consultants for the privatization of those companies.

A new Privatization Act was adopted in March 2002, which introduced a number of positive changes: the preferences awarded to MEBOs (management-employees' buyouts) were abolished and direct negotiations with potential buyers without a bidding procedure were suspended. These changes aim to enhance transparency, guarantee equal treatment of all bidders and limit the scope of corruption.

Restructuring of natural monopolies

The changes in the regulatory environment of the natural monopolies where state participation has been traditionally strong have influenced most positively the sectors of telecommunications and energy. After the successful completion of the bid for a second GSM operator, the competition in the sector became much stronger. The prices of mobile telephone services fell, the range and quality of the services increased and by mid-2002 the number of subscribers almost doubled. The ban was lifted for the analogue mobile-service provider Mobikom to build a digital network. Mobikom is expected to start offering CDMA services (a transitional phase before the introduction of third-generation mobile services) by mid-2003. Frequencies for a third GSM operator will be freed then and the competition will grow further. The admissibility of separate bids for a third GSM operator is another positive development in the BTK privatization strategy. It will broaden the circle of potential bidders and guarantee transparency of the investor’s interest as well as conditions for an even stronger competition. At the same time, a large number of Internet based companies or call-back systems entered the phone-service market, which resulted in a fall in the price of international and long-distance calls. BTK’s monopoly on fixed lines expires at the end of 2002, which will open the way for another wave of new companies entering the sector.

Concrete parameters for an overall 50% rise in consumer prices of electricity and district heating for the 2002-2004 were negotiated with the IMF and the World Bank in order to achieve full cost recovery and to eliminate the cross subsidies in the sector. Conditions were created for direct negotiations between local electricity and gas producers and the big industrial companies, which would limit the monopoly power of state-owned suppliers in the sector. Differentiated prices driven by economies of scale were introduced for natural gas deliveries. The introduction individual district heating accounting standards would raise the households' propensity to save energy. The installation of individual heat-flow gauges is expected to be completed by October 2002. Private firms are now in charge of the new heat consumption account, which broadens the role of private companies in the sector. In April 2002, the government adopted a new energy strategy in accordance with the recommendations made by the World Bank for a transfer of the investment risk to the private sector. The government has also advanced draft legislative amendments aimed at the elimination of the state monopoly over nuclear energy. All these changes improve the investment climate in the energy sector. That sector proves to be an important factor for the attraction of foreign direct investments into the country. The preparatory work has already started for the implementation of the plans for the USD 1.4 billion investments to be made by the U.S. companies AES and Entergy in accordance with the agreement concluded in May 2001. EBRD will provide short-term financing for energy projects for some euro 300 million and will manage an international donors' fund of euro 500 million for the modernization of nuclear energy and the closure of old nuclear reactors.

Pension insurance and insurance market
The end of September 2001 saw the completion of the selection procedure for a pension fund as part of the second pillar of compulsory pension insurance. As of the beginning of 2002, real redistribution of individual pension contributions made by employees born after 1959 was launched. All of the eight licensed pension funds managed to collect the minimum level of registrations and in the long term are expected to secure a pension to the amount of 25% of the average pre-retirement income. The contributions for the second pension-insurance pillar will increase from 2 to 5-7 % of the personal income in 2005 at the expense of lower installments in the first pay-as-you-go pillar. The assets of private pension funds from the second and third pillars are expected to reach BGN 2 bln. by the end of 2005 according to the estimates of the Agency for Insurance Supervision. These resources will represent about 5% of GDP and will turn the private pension funds into the country's biggest non-banking financial sector. About 60% of the financial resources will be managed by universal or professional funds from the second pillar while the remaining 40% will be managed by funds from the third pillar handling voluntary pension insurance. The number of persons insured in private pension funds will grow by 20% in the 2002-2005 period to about 2 million people (25% of the population) and the assets of these funds will rise 3.5 times over the same period. Parallel to the expansion of private pension insurance, the upward trend continued in the insurance market. The revenues from the all-risk insurance premiums grew by 20% in 2001 and by 25.5 % in the first quarter of 2002 compared the same period in 2001. In early 2002, the existing monopoly in the market for green-card car insurance for travels abroad was abolished.

Market reform in agriculture
Bulgaria was the first country to start a SAPARD program in 2001. A large number of banks signed agreements with the SAPARD Agency. A considerable number of projects were approved and funds have already been practically absorbed in the context of the program. Thus, Bulgaria maintains its leadership position as regards the implementation of the SAPARD program as compared to the record of the remaining EU membership candidates. The process of restitution of private ownership rights over land was completed as early as the end of 2000 and by early 2002 more than 90% of the private ownership rights over nationalized forests were restituted. The restitution of private ownership rights over forests brought along a heightened interest in lumbering and related businesses. The World Bank plans to extend a 60 million-euro funding facility for support of the wood-processing industry with the aim of job creation in high-unemployment areas dependent on the availability of wood resources.

3. Compliance with the Copenhagen Criteria

3.1. Criteria for a functioning market economy

3.1.1. Price and Trade Liberalization

The regular reports by the European Commission and the EBRD assessed the degree of price and trade regime liberalization as being comparable to the norms defining the existence of a functioning market economy. The EBRD 2001-2002 report on the countries in transition gives Bulgaria's trade regime the highest evaluation. The high level of foreign trade liberalization was reconfirmed by the World Bank report, published in early 2001 (Bulgaria - Country Economic Memorandum: The Dual Challenge of Transition and Accession). No significant changes have taken place in the price control and monitoring policies in the period after the publication of the latest report by the European Commission on the Progress towards Accession by the Candidate Countries (November 2001). At the same time, the trade regime liberalization has continued according to the medium-term commitments made by Bulgaria.

Price liberalization

The groups of directly controlled and monitored prices remained unchanged in 2002 as compared to 2001 but as a result of changes in the relative weight of these groups in the consumer basket, slight changes occurred in the overall weight of the regulated prices. The share of directly controlled prices fell from 16% in 2001 to 15.1% in 2002 (Table 3). The basic factor behind this fall is to be found in the group of telephone services. Thanks to the development of mobile telephone services, the share of state-regulated telephone services already has a lower weight in the consumer basket. The share of monitored prices went up from 4.6% in 2001 to 6% in 2002, mainly because of the drinking-water price rise recorded at municipal level. The overall weight of directly controlled and monitored prices increased from 20.6% to 21.1% (Table 3). State intervention is concentrated on a very narrow range of goods whose price has significant social implications. The cigarette price control makes the only exception, which aims at improved excise tax collection.

Table 3. Controlled prices in the consumer basket

Goods and Services	Relative Weight in the consumer basket (%) for 2001	Relative weight in the consumer basket (%) for 2002
Fixed prices	**16.022**	**15.141**
Electricity	7.787	7.572
Heating energy	1.934	1.715
Postal and land telephone services	3.340	2.974
Cigarettes	2.961	2.880
Monitored prices	**4.573**	**6.015**
Water for the population (drinking water)	1.089	2.355
Medicines	3.484	3.660
Total	**20.595**	**21.156**

Source: *National Statistics Institute*

VAT exemptions for Bulgarian-made pharmaceuticals and for several groups of services were eliminated in early 2002 thus reducing the influence of the tax system on the relative prices. The unified VAT rate was preserved. It is extremely important to note that Bulgaria is one of the few European countries where no differentiated VAT rates are applied. The standard market pricing indicators cannot capture this factor, but, in fact, it represents an indirect state interference in pricing, which does not exist in Bulgaria.

Trade regime liberalization

The liberalization of foreign trade regime has continued in compliance with the agreements with the EU, CEFTA and the IMF. Bulgaria does not apply trade limitations outside the customs tariffs. The industrial goods' imports from the EU, CEFTA, EFTA and Turkey have been fully liberalized since the beginning of 2002 and no custom duties are imposed on the whole nomenclature of industrial goods. For countries, which are not parties to the free trade agreements with Bulgaria, the weighted average customs duty rate for industrial goods has been reduced from 6.13% to 5.18% in 2002. The industrial goods customs duty average for all trading partners has dropped from 1.33% to 1.05%. The average duty rate for all kinds of goods and trading partners has gone down from 12.42% in 2001 to 11.29% in 2002, the reduction for agricultural goods being from 21.93% to 20.59%. The standard deviation has been narrowed between the different levels of the applied rates. Bilateral free trade agreements were signed with Croatia and Estonia in late 2001. These agreements could further reduce the expected levels of weighted average customs duty rates since their role has not been factored in the calculations.

Bulgaria continues to meet the criteria for the price and trade regime liberalization. This finding has been confirmed in the latest Regular Report of the European Commission and in the period after its publication further progress has been made mainly in the area of trade regime liberalization

3.1.2. Barriers to entry and exit

In our previous analysis (dating from mid-2001) of the fulfillment of the economic criteria for the existence of a functioning market economy we concluded that Bulgaria meets the conditions for free entry and exit. Our conclusions were backed by statistical data and by an international expert assessment conducted by EBRD on the legislative environment and its implementation. According to the EBRD estimates for 2001, Bulgaria ranks in the top half of the list of EU membership candidates with regard to that criterion (See Table 4). Bulgaria was graded among the front-running candidates in the field of trade legislation and its implementation capacity in the sections concerning the Commercial Code, the insolvency and winding-up procedures, as well as the bank supervision. The dynamics of the statistical indexes as of May 2001 have convincingly reaffirmed our conclusion that there are no serious barriers to market entry or exit.

Table 4. Assessment of Trade Legislation and its Effective Implementation *

	Legislation	Effectiveness and Implementation	Total
Czech Republic	3	3+	3+
Estonia	4-	3+	4-
Hungary	4	4-	4-
Latvia	4	4-	4-
Lithuania	4	3+	4-
Poland	4-	4	4-
Slovakia	3	3	3
Slovenia	4	4-	4
Bulgaria	4	4-	4-
Romania	4-	3+	4-
Bulgaria's standing (1 to 10)	**1-5**	**2-5**	**1-5**
Bulgaria's Standing within the Helsinki group (1 to 5)	**1-3**	**1-2**	**1-2**

Source: *EBRD, Transition Report, 2001*
**Grades range from 1 (minimum) to 4+ (maximum)*

Entry barriers

In the period May 2001-May 2002 the number of active companies registered under the Commercial Code has grown by an impressive 21% from 658 334 up to nearly 800 000 registrations or 1 company per 10 persons of the population. Private economic entities account for more than 99% of all registrations. There is an increase in the number of VAT-registered companies. By the end of March 2002 they reached the figure of 65 934, which represents an increase by 6.6% compared to the same period of the previous year.

As to the license regimes, the Council of Ministers approved in late May a decision for the full abolition of 74 out of 360 existing licenses and other permits as well as for easing another 120 of them. This marked the continuation of the previous government's policy for gradual reduction of the number of license regimes, which was launched in 1999. The provision was struck off which had made possible the introduction of new similar regimes through government regulations, which substantially enhanced the transparency and predictability of the legislative environment. The government has committed itself before the IMF and the World Bank to continuously reduce the scope and negative impact of these regimes and to optimize their implementation.

The changes in taxation that came into force in early 2002, as well as the recently announced tax reforms for the 2003-2005 period, will be conducive to the increase in investment activity and the entry of new economic agents into the Bulgarian market. The positive factors in that direction are reduction of income tax burden for legal and physical persons, abolition of some tax exemptions and sector unification of the tax burden. The neutral tax policy with regard to the sector development is a guarantee that the free financial resources will be distributed solely on the basis of market principles. The existence of a unified VAT rate and the minimal number of tax exemptions place Bulgaria among the leading nations in Europe with regard to the requirements for tax unification.

Exit barriers

Nearly 10,000 companies (i.e. 6% of the newly registered) have terminated their registration in the period May 2001-May 2002. The ratio between terminated and active registrations since the establishment of the register until May 2001 was 2.9% and it rose to 3.4% by May 2002.

The fiscal policy of limiting subsidies for state enterprises has continued thus forcing inefficient enterprises to go into liquidation or to privatize their inefficient activities and autonomous units. Subsidies for non-financial enterprises as laid down in the 2002 draft budget account for the extremely small share of 0.7% of GDP thus maintaining their last year's share and recording a drop in comparison to the figures for 2000 and 1999 (0.9 % and 1.4 %, respectively).

The implementation has been underway of a medium-term austerity program in the railroad, mining and central heating sectors, which are the key loss-making budget items. The implementation of the program has been monitored by the IMF and the World Bank. The subsidies for the Bulgarian State Railroad Authority have been gradually curtailed on an annual basis. An agreement has been reached with the EBRD for the modernization of thermal power plants and the reduction of energy transfer losses. Most mines have already been privatized or closed down. The negotiated 50% increase in consumer electricity and heating prices in the period up to 2004 will ultimately clear away all subsidies for energy companies. All the budget restrictions and the price rises create favorable conditions for entry of private investors and liquidation of inefficient state-run structures.

Lists of the largest state budget debtors have been made public, which aims to secure transparency with regard to the indirect forms of subsidizing in the event of overdue liabilities. Some of the big state monopoly companies resumed their direct or indirect claims for debt write-offs to the state budget. In the case of "Bulgargas" company or the Bulgarian State Railway Authority, the government demonstrated some inclination towards meeting these demands thus trying to compensate for certain market deficiencies but, on the other hand, creating conditions for restrictions to the free exit from the market.

In May 2002, members of the government and Parliament proposed amendments to the Commercial Code aimed at speeding up the liquidation procedures. The proposed changes include the establishment of courts specialized in insolvency and winding-up procedures and extended creditors' rights to collect receivables.

Statistical data on the dynamics of registration and liquidation of companies in 2001 and early 2002 show the absence of serious barriers to free market entry and exit. The neutral tax policy of Bulgaria with regard to sector development is a guarantee that there are no barriers to the free distribution of financial resources based on market principles. As far as the legislative environment is concerned, the scope of license and permit regimes was considerably narrowed. The key problems are related to the speed of implementation of liquidation procedures. However, these problems do not create a serious amount of arrears to the state budget and the private sector. Trade legislation

has been harmonized with that of the EU and changes have been underway aimed at speeding-up the procedures of bankruptcy and liquidation.

3.1.3. Legal system. Implementation of legislation and Enforcement of Contracts

Courts

The second half of 2001 and early 2002 witnessed a more active performance by the courts with regard to company lawsuits. The first quarter of 2002 saw the publication of more than 2,700 new company registrations in the State Gazette, 211 liquidation procedures have started, 79 companies were declared illiquid and 60 were pronounced insolvent. Compared to the same period of 2001, the number of registrations remains the same but there is a significant drop in the number of liquidations while the illiquidity and insolvency procedures have increased considerably. So far as these procedures demonstrate the capacity of the judicial system to impose hard budget constraints on the business sector, the rise in their number shows the enhanced capacity of the courts to apply market rules as a third unbiased party.

By the end of 2001 the problems related to the judicial system continued to exert a certain degree of negative influence on the effective functioning of the Bulgarian market economy. On one hand, the trends continue towards improved performance by the courts, a rise in the predictability of their rulings and the greater stabilization of judicial practices. On the other hand, however, the operational speed of the various courts continues to lag behind the dynamics of the rise in overall economic activity in the country. Moreover, the ongoing economic growth brings about greater complexity of business interaction and the emergence of new negotiating instruments, mechanisms and interrelations. This, in turn, raises the level of requirements to the performance of the judicial system. It means that even though at present courts are in a position to meet the basic needs of the economic exchange, the rate of modernization of their functioning and of their capacity to adequately respond to new requirements will have to outpace that of the overall economic development.

The judicial system reform

In response to the requirements to the judicial system described above, in 2002 the Bulgarian Council of Ministers adopted a “Strategy for a Judicial System Reform in Bulgaria” and a program for its implementation which were submitted before the European Commission and presented for professional and public discussion.

So far draft amendments to *the Judicial System Act, the Penalty Execution Act, the Penal Code, the Commercial Code, the Code of Civil Procedure etc.* have been elaborated and advanced to the Bulgarian National Assembly in conformity with the reform strategy.

The most important amendments to *the Judicial System Act* which have already been passed by an overwhelming parliamentary majority on first reading are designed to improve the quality of the law-enforcing capacity of the judicial system through the introduction of competitive principles and practices in the selection and promotion of judges, prosecutors and investigating magistrates, the introduction of mandates of office for senior positions in the judicial system, through transparency of the annual income of judges, prosecutors and investigating magistrates. Greater transparency will also be achieved in the work of the judicial system through the regular provision of information on the number of cases filed and closed etc.

The amendments to *the criminal legislation* will lead to the introduction of European standards in criminal law policies, the penalty system and the prison-and-arrest premises. *The Commercial Code* amendments envisage the incorporation into Bulgarian legislation of the requirements contained in the European directives on the transformation of companies registered under the Commercial Code. Legislative amendments will soon be proposed aimed at sophistication and acceleration of the insolvency procedures. *The Civil Code* amendments are designed to improve and speed-up judicial proceedings and access to justice.

Over the next few months steps will be taken to establish a National Justice Institute on the basis of the Magistrate Training Center as well as for the development of educational programs, lecturer training etc. The establishment of such an institution aims to provide the compulsory specialized training for judges, prosecutors and investigating magistrates and bring about an improvement in the quality of their work. A strategy is being designed for the comprehensive computerization of the judicial system and for budget planning and approval as a guarantee for the implementation of the judicial reform, as well as for the preparation of draft legislation linked to the judicial reform etc.

Market framework of property rights

The market framework of property rights continues its improvement and 2001 and early 2002 marked a positive trend in the land, labor and capital markets.

Following the completion of the process of restitution of real property rights over land in populated areas and over arable land in Bulgaria in 2000, the process of forest land restitution was practically over by April 2002 as at the end of April 2002 more than 90% of the forest land property was restituted to their legitimate owners (http://www.nsi.bg). Thus, land property rights in Bulgaria are restored and enforceable. At the same time, the process has continued of providing greater transparency and liquidity of these rights through procedures envisaged in the Cadastre and Property Register Act (which entered into force in January 2001) but there is a lot of work to be done for the satisfactory completion of the process. According to data provided by real-estate firms and the Ministry of Agriculture, there are areas in Bulgaria where the land and real estate markets are relatively well developed and record some growth. In the case of real estate, these are mainly the cities, which account for a quarter of the country's population, whereas in the case of agricultural land, these are primarily the Northeastern and South-Central planning regions making up more than one third of arable land.

The trade in warehouse receipts for grain intensified and the turnover of that financial instrument increased. Preliminary data indicate that at the end of 2001 the capacity of the licensed public warehouses and grain stores amounts to nearly 1.4 million tons, which accounts for more than half of the country's annual needs and about 40% of the average annual yield. Compared to the previous year, the amount of credits backed by warehouse receipts has doubled and has exceeded BGN 11million, with at least 6 Bulgarian banks engaged in such a form of crediting (according to the project consultant ACDI/VOCA).

2001 marked a significant rise in the issue of and trade in mortgage bonds offered by a number of banks some of which are preparing new issues. Coupled with the entry into force, as of early 2002, of the regulation for additional compulsory social security contributions, these issues have been at the root of the increased availability of longer-term financial instruments in the Bulgarian economy and have marked the beginning of the development of this important segment of the financial markets.

According to the IMF Country Report, No.01/100 the labor market in Bulgaria could be described as relatively flexible. Even though slowly, the capacity of the private sector to create jobs has improved and since July 2000, for two years now, the total number of unemployed (after seasonal adjustments) in Bulgaria has shown a constant downward trend. This trend, however, is still slow and the overall Level of unemployment remains relatively high due to the ongoing structural changes in the public sector. The Labor Code amendments passed in the first half of 2001 have not exerted any visible influence on these two tendencies. At the same time, the speedy and predictable settlement of industrial-dispute cases remains one of the most serious challenges to the judicial system.

Regulation

Though at a slower pace, the gradual improvement of the capacity of the state to regulate civil and, in particular, business relations has continued. The current slow-down could be attributed to the changes in the upper echelons of the state administration following last year's parliamentary elections. Pursuant to the newly adopted Electronic Media Act, which came to replace in November 2001 the then Radio and Television Act, a new regulatory body called

Electronic Media Council was set up and tasked to regulate and control the products of the respective media.

At the end of 2001 the Council of Ministers split the functions of regulating the insurance market and the gambling sector, respectively, by setting up two new agencies. The administrative division of these two types of activities, which are very different from each other in nature and mechanisms of work, is a prerequisite for an improved quality of these regulatory functions. However, the new agencies have been operational for such a short period of time that any quantitative assessment would be premature.

The beginning of 2002 saw yet another revision of Bulgaria's energy strategy. The new government thus reaffirmed and enhanced the tendency underlying the latest prior changes to the strategy, which had aimed to consolidate as the best model under the Bulgarian conditions the free access of third parties to the energy network rather than the adherence to the single-buyer model. The strategy also envisages the further sophistication and strengthening of the regulatory authority of the State Commission for Energy Regulation.

The Bulgarian state's administrative capacity to regulate business relations has been improving and at present is relatively adequate to the economic processes and the functioning of market economy in the country. In view of the potential for the execution of obligations deriving from EU membership and to match the pace of the ongoing economic development, that administrative capacity will have to grow at a faster rate.

Implementation and ?nforcement of laws and contracts

Throughout 2001 and in early 2002 the process of the improvement in the quality of law implementation and contract execution continued to a degree which makes it possible for Bulgaria to meet the requirements of a functioning market economy. However, that improvement should go much further so that the sustainability of meeting the said requirements could be guaranteed.

Preliminary data published by the National Statistics Institute (http://www.nsi.bg) show that the 2001 crime rate tended to decline. At the same time there is a rise in the crime punishability rate, especially concerning property offences.

Bulgaria has moved up from position No. 66 to position No. 47 for the 1998-2001 period in the international index of corruption perception published by Transparency International. The indicators are almost identical with those for the Czech Republic and Poland but Bulgaria still lags behind as compared to Estonia, Hungary, Slovenia and Lithuania (http://www.transparency.org). The indicators used by the non-governmental organization Coalition 2000 (http://www.online.bg/coalition2000) in the period between April 1999 and October 2001 the objective corruption indicators recorded a constant declining trend at consistent low levels, whereas the indicators of subjective perception were stable. The biggest drop in corruption expectations by respondents was registered during the last period under study, i.e. January-October 2001. The overall weighted index based on these data declined from 3.88 to 3.63, remaining stable just during last year.

The overall assessment from the review of Bulgaria's legal system shows that as a result of its improved performance over the last years Bulgaria is capable of servicing the needs of the functioning market economy in the country. Nevertheless, the legal system will have to continue improving its performance at a faster rate so that the said capacity could become sustainable in the conditions of a relatively rapid development of the country's economy. The ongoing phase of the reform is heading in that direction.

3.1.4. Macroeconomic stability

In the second half of 2001 the Bulgarian economy began to feel the effects of the recession, which hit key partners like the EU and Turkey. Nevertheless, real economic growth was stable at the rate of 4% for 2001, distributed in a relatively equal fashion quarter-wise. That growth was driven by one basic factor - investment demand. Exports were another driving force in the first half of that year but in the third quarter they leveled off and then declined in the fourth. The export dynamics defined also the fall in industrial sales at the end of 2001 and the first quarter of 2002. The recession affecting Bulgaria's key economic partners was the main cause behind the emergence of these negative tendencies. So far, their effect on the Bulgarian economy has been limited and is not in a position to reverse the GDP growth dynamics, which is expected to reach 4% at end-2002.

The external factors mentioned above underlie the increase in the current account deficit in 2001 but they were fully compensated for by the continued inflow of foreign direct investment and other financial-account revenues so that there was a balance-of-payment surplus in 2001. This contributed to the ongoing reduction in the overall Level of public debt in absolute terms as well as a percentage of the GDP. The beginning of 2002 saw a decline in direct investment inflow, which could be explained by the global rise in investment risk following the terrorist attacks of 11 September 2001 and by the slow-down in the privatization process in Bulgaria linked, to a great extent, to the sluggish economic performance by Bulgaria's key partners.

In 2001 Bulgaria continued its restrained fiscal policies and scored a budget deficit of less than 1% of the GDP, which would guarantee its macroeconomic stability and money supply control under the terms of the currency board. Although, in the end of 2001 and the beginning of the 2002 Bulgaria's economy recorded inflation rate atypically high for the season. The inflation rate is due to a variety of non-monetary factors like the rise in three groups of administratively controlled prices (electricity, cigarettes and the imposition of VAT on medicines) as well as the rise in oil prices. Most of these factors have a one-time effect and do not threaten the future price stability, which is evidenced by the April 2002 deflation.

Despite the trend over the last two years towards a decline in the seasonally adjusted unemployment, this indicator remains relatively high due to the intensive structural changes and calls for additional efforts aimed at a greater flexibility of the labor market. It is evident that all countries with currency boards/fixed exchange rates continue to maintain a high level of unemployment. Still, it affects Slovakia the most. (See Table 1)

The comparative analysis of the 2001 macroeconomic indicators of the EU membership candidate-countries demonstrates Bulgaria's very positive development. (See Tables 1 and 2). During the 1998-2001 Bulgaria recorded a higher-than-average GDP growth among the EU membership candidates. Bulgaria's growth was much above the figures for countries like Latvia, Slovakia and especially Romania from the Helsinki group. The average inflation (6.2%) for the whole period since the introduction of the currency board in Bulgaria is considerably lower than the average rate for EU membership candidates (9.5%) and even more so if compared to countries like Romania or Slovakia (See Table 1). Under the terms of the currency board the stability of Bulgaria's economy could be made vulnerable by a current-account deficit if the latter would not be fully compensated for by the inflow of foreign investment and if the government did not conduct a systematic policy of low budget deficits (See Tables 1 and 2). In comparative terms, Bulgaria keeps its current account deficit at lower-than-average Level among the EU membership candidates and especially as compared to the figures for Latvia and Slovakia. As to the budget deficit, Bulgaria maintained the lowest value as percentage of the GDP average for the 1998-2001 period. Estonia is the only country, which outdoes Bulgaria in 2001 in this category (See Tables 1 and 2). The comparative analysis of the key macroeconomic indicators proves that not only in 2001, but throughout the period since the introduction of the currency board system Bulgaria has managed to establish the necessary conditions for the sustainability of its macroeconomic stability.

The overall assessment of macroeconomic stability indicates that in the five years following the introduction of the currency board in mid-1997 Bulgaria continues to be one of the countries with the most stable indicators conducive to the functioning of the market economy. That conclusion is even more categorical if the comparison is drawn within the Helsinki group candidates. The objective analysis of economic indicators is an unequivocal proof that Bulgaria has established a track record of macroeconomic stability.

3.1.5 Broad consensus on the major directions of economic policy

The government program advanced by the political force, which won the majority of the electoral vote at last year's parliamentary elections has maintained the fundamentals of the macroeconomic policy of its predecessors and is based on the consensual support for the currency board. This represents a guarantee for the adherence to the norms of a functioning market economy, and for the deepening of both the structural reforms and the legal and economic integration with the European Union.

Notwithstanding the broad consensus, obviously there still exit social groups, which do not accept the major directions of the present economic policy. The elections showed that these groups and their political representatives are marginal which, however, does not totally exclude their ability to attract, under certain circumstances, the confidence of larger segments of society.

In Bulgaria there exists a broad public consensus on the major directions of economic policy aimed at the preservation of the currency board system, which guarantees the stable and predictable functioning of the country's market economy. The opponents are marginalized and they could gain in popularity only under certain unlikely circumstances. In the course of the last five years since the introduction of the currency board Bulgaria's economy maintains macroeconomic stability and higher predictability, which are conducive to the functioning of markets.

3.1.6. Eexistence of a developed financial sector

Legislative and regulatory changes

Irrespective of the fact that the banking system is stable and there is a good degree of compliance with prudential regulations, additional efforts have been made to design and introduce a working *Bank Insolvency Act,* update the *Bulgarian National Bank Act*, *the Banking Act* and *the Bank Deposit Guarantee Act* in order to build a better regulatory and supervisory framework.

The Bank Insolvency Act is expected to pass second reading by mid-2002. The passage of this act will contribute to speeding up the liquidation of closed banks. The draft envisages that the Deposit Guarantee Fund will be authorized to exercise control over liquidators. Amendments, introduced into *the Banking Act and the Bulgarian National Bank Act,* enhanced the protection of banking and commercial secrets. They also regulate the access to information on assets and transactions involving accounts and deposits of persons who are subject to official investigation under the terms and order provided for by the Act on Protection of Classified Information. The amendments to the two acts open the way for inquiries into the origins of bank shareholders. The amendments to the *Bank Deposit Guarantee Act* aimed at increasing the amount of guaranteed deposits. These amendments fully guarantee personal deposits with a bank irrespective of the number of accounts up to the aggregate amount of 10,000 BGN. At the same time, the amendments provide government guarantees for loans used by the Guarantee Fund, thus facilitating the increase in its capacity to cover fund shortages through the use of loans from Bulgarian and foreign banks as well as from the state budget, following a decision by the National Assembly.

Further improvement of the legislative framework in which the financial sector operates was achieved thanks also to the *Accounting Act* and the changes, which *the Measures Against Money-Laundering Act* underwent. The expected passage of the Accounting Act by early 2003 will enable the full application of international accounting standards.

Parallel to the improvement of the legislative framework, the Bulgarian National Bank took steps to improve its own regulations. In R*egulation No.4* the existing limits for open foreign currency positions were reduced and the mechanism for the calculation of a net open position as the bearer of net foreign currency risk for the bank was corrected. In *Regulation No.7*, which treats the big loans of banks, amendments have been made aiming at easing the restrictive regime of risk concentration assessment with regard to an individual client or related persons. In *Regulation No.8* treating the capital adequacy of banks certain restrictions have been eased in the valuation of credit risk for banks. A new *Regulation No.17* was adopted with the aim to establish the deposit amount of banks pursuant to Article 30 of the Banking Act. Changes were introduced to *Regulation No.9* treating the evaluation of banks' risk exposure and the allocation of provisions to cover the related risks thanks to which an improvement in provisioning was achieved. A requirement for banks has been introduced to gather sufficient information about their debtors.

Structural changes

Since the latest Regular Report, efforts have been directed towards further intensification of financial intermediation and efficiency as well as towards consolidating the success achieved with regard to the stable operation of the banking sector. More steps have been taken towards the privatization of the remaining state-owned banks: State Savings Bank and Biochim Bank, and towards the improvement of the payments system.

82 % of the assets of Bulgarian banks have been privatized, with more than 76% of them owned or controlled by foreign banks. By the end of 2001 the state share of bank assets was 17.6%, with municipal capital accounting for 2.5% of them. The government has eversince continued to implement its privatisation program for the remaining state-owned banks. The privatization of the remaining state-owned assets of Central Cooperative Bank was completed. A strategy has been elaborated for the privatization of State Savings Bank. Bids have been launched for the privatization of the State Insurance Institute and of Biochim Bank, and an exclusive buyer has already been selected for the latter. A small business promotion strategy is being drafted in the context of which appropriate restructuring of Encouragement Bank is to be adopted.

In general, the privatisation and enhanced presence of foreign banks and branches exercise a positive influence on the efficiency and restructuring of the banking sector in Bulgaria. In the case of foreign banks, the ratio of gross operating expenses to gross operating income, a common indicator for efficient management, declined substantially from 67% in 1998 to 41% in the first half of 2001.

The joint work with the U.S. Montran Corporation on the establishing of the RTGS system continued. In the autumn of 2001 a joint team from the Bulgarian National Bank and Montran Corporation began working to speed-up the introduction of a new payment system, which would meet all EU and EMU payment system criteria. The introduction of the new RTGS system is expected to be finalized in the autumn of 2002.

In early 2001 the Electronic Budget Payments System (EBPS) became operational, including the majority of the first-level spending units. The Electronic Budget Payments System exercises control over payments made by the first-level spending units included in the Single Treasury Account.

In the period after the latest Regular Report the efforts of establishing an effective and well functioning capital market continued. The Bulgarian Stock Exchange provides a good trading system whose capacity exceeds manifold the currently traded volumes. The system is fully automated and guarantees a maximum degree of transparency and availability of information. Despite the positive results in the development of capital markets and the stock exchange in particular, the prospects for an increase in the number of companies listed on the stock exchange are not that encouraging since most of Bulgaria's big companies have strategic investors and alternative sources of fund-raising, and therefore, would hardly like to comply with the strict listing requirements. There is also a tendency of migration of high-quality listings from small to bigger stock exchanges.

Further improvement of the insurance company supervision has continued both in legislative and institutional terms. Efforts have been made to establish a joint supervisory body of both the banking and non-banking financial sectors (securities and insurance), which guarantee a regular exchange of information, better coordination and closer cooperation.

The progress in pension reform has also continued since the latest Regular Report. The private pension funds licensed in 2001 began to collect pension insurance contributions from persons born after 1959. The legislative and institutional framework of the Bulgarian pension reform has already been completed to a considerable extent. On that basis the reform will advance in the framework of a medium-term program, which will support the implementation of the new pension system and will further develop its legislative and institutional framework.

Monetary and credit aggregates developments and compliance with prudential regulations

In accordance with the specifics of the currency board the Bulgarian National Bank (BNB) did not use the limited instruments it had at its disposal and, in turn, did not exert any direct influence on the money supply in the period after the latest European Commission Regular Report. The lower level of foreign currency reserves observed throughout most of the year did not lead to lower money supply as it was linked to some decline in government deposits. This specific feature of the Bulgarian currency board provides for a stable behaviour of monetary aggregates even in the case of falling foreign currency reserves as long as the latter is caused by changes in government deposits with the Issue Department of the BNB.

In the end of 2001 compared to the end of 2000 the broadest monetary aggregate M3 grew nominally by 24.8% and by 19.9% in real terms. The increase in the M3 is due to the increase by more than 28% in its lev component and to a lesser extent of its foreign currency component. The recorded real rise in money supply is the highest since the introduction of the currency board, which testifies to a further intensification of the process of money demand recovery and to the remonetization of the economy after the systemic financial crisis of 1996-1997. The first quarter of 2002 saw a continuation of the M3 growth both nominally (by 21.2%) and in real terms (by 11 %) as compared to the first quarter of 2001. In 2001 the M3-to-GDP ratio reached 33.6%, recording an increase of 3.3 p.p. The latter increase is due to the rise both in the deposit base and currency in circulation. Quasi-money, being a component of M3, preserved its stable upward trend with its lev component growing faster than the foreign currency component. Despite the fact that the relative share of the foreign currency component of quasi-money began declining, it remained higher than that of the lev component. The stable quasi-money growth implies a rise in banks' lending capacity whose utilization depends both on the conditions under which commercial banks operate, and the pace of real sector restructuring, which, in turn, determines the demand for loans.

From a money supply perspective, the 2001 M3 growth was entirely due to the monetary base (reserve money) growth by 33.5% in nominal terms and by 27.4% in real terms. The money multiplier registered some decline from 3.08% at the end of 2000 down to 2.88% at end-2001. In the first half of 2001reserve money growth was entirely due to the rise in net domestic assets, while the Issue Department foreign currency reserves went down because of the fall in government deposits. On an annual basis, both net foreign assets and net domestic assets contributed to the growth of reserve money.

Domestic credit grew by 17% in nominal terms and by 12.2% in real terms, which was entirely the result of further intensification of banks' lending activity. Domestic credit growth continued both nominally (by 22.57 %) and in real terms (by 12.3%) in the first quarter of 2002 compared to the same period of 2001. In 2001 net credit to the government recorded once again a decline. Credit to non-financial state-owned enterprises continued to go down and recorded a real decline of 22.6%, which was linked to the decline in the overall public sector share. Credit to private firms continued growing and by the end of 2001 registered a nominal increase of 21.1% and real growth of 15.6% as compared to 2000. Consumer loans recorded a much higher real growth of 38.5% and nominal growth of 45%. Private sector credit (credit to private firms together with consumer loans) continued to grow in the first quarter of 2002 both in nominal (24%) and in real terms (13.6%) as compared to the first quarter of 2001.

By the end of 2001 private sector credit, including consumer loans, reached 15.7% of the GDP as compared to 14.7 % at the end of the previous year. The period following the introduction of the currency board has been characterized by a gradual decline in domestic credit and a growth in the private sector credit as a percentage of the GDP (Table 5). The decrease in the relative share of domestic credit as a percentage of the GDP has been a result of the continuous reduction in credit to the government and state enterprises. Private sector credit has been the only continuously increasing component of domestic credit since the currency board introduction (Table 5).

Table 5. Bulgaria: credit indicators

Percent of GDP

	1998	1999	2000	2001
Domestic credit	20.7	19.0	18.3	18.5
Private Sector Credit	11.6	13.5	14.7	15.7

Source: *Bulgarian National Bank (BNB)*

Commercial banks continue to recover their deposit base, which fell sharply during the 1996-1997 banking sector crisis. Banks have not reached their pre-crisis lending capacity yet, but, nevertheless, continue to invest part of their assets in foreign banks, though their share began declining since late 2001 due to low interest rates. Banks still operate below their lending capacity, but, if financial intermediation is assessed from the viewpoint of prudent banking, it proves to be appropriate and adequate to the conditions under which banks operate and if these conditions improve lending would easily increase.

The Bulgarian banking system is strongly influenced by the presence of foreign banks and their experience and efficiency. Their more conservative lending policies are conditional upon an environment that has been affected by the general confidence crisis of 1996-1997. Banks' conservative lending policies could also be explained by the unstable borrowers' base linked to the ongoing intensive restructuring of the corporate sector, the shortage of credible collateral and difficulties in its realization, difficulties in enforcement of laws and contracts, overly restrictive legislation, etc.

The method of determination of the base interest rate was preserved but the issue schedule of government securities was changed from once a week to twice monthly. In 2001 the average annual base interest rate (BIR) reached 4.56% up from 3.92 % in 2000. At the end of the first quarter of 2002 the BIR reached 4.5%. The drop in interest rates on the international markets affected neither the BIR nor the interest rate policies pursued by commercial banks. The new short-term lending rates grew by 0.78% compared to their 2000 rates but remained below lending rates in previous years. The one-month deposit rates remained at their last year levels. Interest spread remained relatively high at 8.4% despite some decline by 1 pp.

The restrictive prudential regulations in Bulgaria are combined with the strict supervision of their implementation. The system of banking supervision has already achieved full compliance with 17 of the core Basel principles, a high degree of compliance with another 7 of them, and non-compliance with only one principle. The supervisory system of compliance with prudential regulations is effective. Effective is also the system of prompt corrective actions based on both on-site and off-site supervision as well as on ad-hoc inspections. The Banking Supervision Department at the Bulgarian National Bank assesses the position of individual banks through the CAMELS international methodology, which rates banks on the scale of 1 to 5. Despite the success achieved in banking supervision, the supervising capacity of the Bulgarian National Bank continues to be improved especially with regard to its capacity of risk assessment.

From the viewpoint of prudential regulation compliance, the Bulgarian banking system is generally sound, highly capitalized, highly liquid and demonstrates low sensitivity to interest and currency risk (Table 6). The banking sector operates in an environment of sound rules and regulations as well as good banking supervision.

Table 6. Select Indicators of Prudential Regulation Compliance

Percent

Indicators	XII-1998	XII-1999	XII-2000	XII-2001	Q1-2002
Overall capital adequacy ratio	37.0	41.3	35.6	31.0	29.52
Standard Loans	87.3	88.3	91.8	92.3	93.50
Highly liquid assets/ deposits:					
Primary liquidity			10.4	13.5	9.99
Secondary liquidity			25.9	25.5	24.25
Open foreign currency positions /capital base		4.6	-4.3	-6.8	-6.24

Source: *BNB*

The average overall capital adequacy ratio of the banking system shows a smooth decline but remains high at about 31% by the end of 2001. This high capital adequacy ratio indicates that banks have big potential to expand their lending activity. Following the introduction of the currency board the relative share of standard loans has been continuously growing. In 2001 it rose even further to 92.3%, with the share of classified loans reaching 9.2% of the overall loan portfolio. The share of loans classified as "doubtful" and " loss" fell from 2.3 % at end-2000 down to 1.8% at end-2001. The best quality was registered by consumer loans: 97% standard and 1% loss. Banks' liquidity remained high under the conditions of the currency board in the absence of a full-fledged lender of last resort. Primary liquidity reached 13.5% at the end of 2001 and secondary liquidity, notwithstanding its gradual weak decline, remained relatively high at 25.5% at the end of 2001. At the end of 2001 the net open currency position reached 6.8% of the capital base, banks' sensitivity to currency risk was low, and risk was under control. The data for the first-quarter of 2002 continued to testify to the stability of the banking system (Table 6).

Table 7. A Comparative Summary Assessment of the 2001 Financial Sector Development in Bulgaria and other countries *

Countries	Banking Reform and Interest Rate Liberalization	Capital markets and non-bank financial institutions
Bulgaria	3	2
Estonia	4-	3
Hungary	4	4-
Latvia	3+	2+
Lithuania	3	3
Poland	3+	4-
Romania	3-	2
Slovakia	3+	2+
Slovenia	3+	2+
Czech Republic	4-	3
Bulgaria's standing (1-10)	**8-9**	**9-10**
Bulgaria' standing within the Helsinki Group (1-5)	**3-4**	**4-5**

Source: *Transition Report 2001, EBRD*
**The scale ranges from 1(minimum) to 4+ (maximum)*

The systemic compliance with prudential regulations gives grounds to conclude that an increase in bank lending would not place the banking system at risk. The stress test, conducted by the IMF and World Bank has proved that the increase in banking intermediation through transformation of 50 % of banks' deposits with foreign banks into loans would lead to a fall of only 4-6 p.p. in the capital adequacy ratio of banks, with the effect being stronger for foreign banks than for Bulgarian banks. These results indicate that the banking system has the capacity to increase its lending without impairing its capital adequacy.

The draft amendments to the Commercial Code as laid down in the program of the government and the Bulgarian National Bank for the period until the end of 2002 would provide better protection of creditors' rights and would speed up the realization of collateral. The implementation of an effective Bank Insolvency Act, improvement in banks' risk assessment capacity, the introduction of international accounting standards as well as of the RTGS system are expected to result in a further increase in bank lending.

The EBRD assessment indicates that Bulgaria's banking reform has reached a level of completeness comparable to that of Lithuania (Table 7). EBRD indicators show that with respect to capital markets and non-bank financial institutions the Bulgarian and Romanian reforms are on the same level.

The summary assessment is that the period following the latest Regular Report has been characterized by a further progress in the development and functioning of the financial sector, which manifests itself in a sustained improvement in the capacity of the banking sector to direct savings to productive investment in the private sector with a simultaneous consolidation of the sector stability and compliance with prudent banking standards. These trends are sustainable, as they have been monitored throughout the period following the introduction of the currency board in Bulgaria in mid-1997. In the period following the latest Regular Report the efforts have continued to build an effective and properly functioning capital market. The Bulgarian Stock Exchange already has a fully automated trading system, which provides for maximum transparency and whose capacity exceeds the current real trading volumes.

3.2 The capacity to cope with competitive pressure and market forces Within the Union

3.2.1 The existence of a functioning market economy and of macroeconomic stability

Bulgaria is a functioning market economy. Prices and trade regimes have been liberalized in accordance with the norms of a functioning market economy. There are no significant barriers to market entry and exit. The legal system has the capacity to service the economic exchange turnover even though the need persists for its substantial improvement with a view to raise the effectiveness of the functioning market economy. The financial sector continues its stable development and keeps improving its capacity to direct savings towards productive private sector investment while adhering to the sound standards of reasonable banking. There is a sustainable macroeconomic stability and a broad public consensus on the major directions of economic policies. There are no medium-term dangers for a reversal of these trends in a direction potentially adverse to the functioning of markets.

3.2.2 Availability of developed human and physical capital

Physical capital

In 2001 the active process of recapitalization of the Bulgarian economy continued following the crisis of the early 90s. Primarily driven by the private sector but also boosted by the investment program of the government the gross capital formation in the 1998-2001 period already reached levels, which made long-term growth prospects more sustainable.

The obsolescence of the predominant part of Bulgarian technologies necessitates their total replacement in public infrastructure and in terms of the production capacities. On the one hand, this makes the process more expensive and difficult, but on the other, it means that Bulgaria has the opportunity to adopt state-of-the-art technologies, which, in the medium-term, could prove to be a competitive advantage. Such a tendency could be traced in the fact that a large share of gross capital formation has been generated mainly by investment goods imported from the EU and by new construction projects.

"Human capital" and knowledge

The development of human capital in Bulgaria has continued to be contradictory. The population decrease continues because of the negative natural population growth and emigration coupled with the rise in average age. On the other hand, the reforms in the sector of education have continued, included through the optimization of the number of schools and of the school network. For the period 1995-2000 the National Statistics Institute (NSI) has registered an improvement in the education structure of Bulgarian society, with the average Level of education in the country being higher than that the average for EU member countries by the end of the above period (NSI and OECD). Computer and Internet access has also increased significantly.

There are three major challenges to the development of human capital in Bulgaria. First, health which follows a negative trend with the new health care system not expected to produce results before the medium term. Second, financing the system of education, especially as regards the advanced Levels of education, where no optimal plan has been devised as yet to finance higher education. Third, the need for an improvement in a specific field of education, i.e. entrepreneurial skills and culture where Bulgaria has considerably lagged behind compared to the EU and where the catch-up pace is relatively slow. Despite these challenges one could expect that, in the medium term, the Bulgarian economy would enjoy the availability of an acceptable Level of domestic human capital, which will enable it to withstand the competitive pressure of the EU market forces.

The processes of recapitalization as well as the implementation of the education and healthcare reforms give us grounds to conclude that in the medium term these two factors will reach a Level sufficient enough for the Bulgarian economy to withstand the competitive pressure of the EU market forces.

3.2.3. Degree of Influence of Government Policies and of Current Legislation on Competitiveness

Competition policy

The National Assembly passed a State Aid Act in early March 2002, which authorizes the Commission for Protection of Competition to be the main body exercising control over the extension of direct or indirect state aid. The new law provides for a clearer regulation of the functions of the Finance Ministry and the Commission for Protection of Competition. In accordance with the principles of the EU, any allocation of state aid packages involving large amounts of money will have to receive the prior approval of the Commission. Thus, the legislation has been fully harmonized with the standards and practices of the EU with regard to the functioning of an independent body exercising control over state aids. The passage of the law would speed up the closure by of the *Competition* chapter end-2002 in the framework of the EU accession negotiations.

After the June 2001 parliamentary elections having brought to power another ruling coalition, the representatives of local companies resumed their demands for preferential treatment in state procurement bids. Following a debate within the ruling coalition, these demands were rejected which led to the preservation of the existing regime of equal treatment of all public contract bidders. All procurement bids are officially published with an Internet-based public register guaranteeing the transparency of the procedure.

The improvement in the regulatory environment in sectors traditionally dominated by the state, led to positive structural changes with regard to competition-promoting conditions and to an actual increase in the number of competing companies. A second GSM operator entered the telecommunications sector and would be shortly followed by a third licensed operator and by digitalization of the existing analogue services. A large number of Internet-based firms entered the telephone services' market and brought along lower prices of long-distance calls. By the end of 2002, the monopoly position of the Bulgarian Telecommunications Company will be fully eliminated. The regime of gas and electricity supplies in the energy sector was partially liberalized after the big industrial consumers were granted the right to directly negotiate with local producers. The free access to state-owned companies in charge of electricity and gas transfers has also been regulated. Private companies supplying gas to consumers and end-users in the trade and services sectors have also been operating effectively. The monopoly has been eliminated over green-card car insurance for travels abroad. The number of city transport routes in Sofia managed on the basis of a concession granted to private firms has increased.

With the passage of the State Aid Act full harmonization has been achieved with the EU directives in the area of competition protection policy. The existence of strong competition driven by imported goods and of regulations directed at limiting the role of monopolies is a guarantee for a competitive environment.

3.2.4. Degree and Pace of Bulgaria's Trade Integration with the EU

Bulgaria's trade integration with the EU has continued to grow at an accelerated pace in 2001 and early 2002, despite the EU economic slowdown. The share of exports to the EU grew from 51.2% in 2000 to 54.8% in 2001 and to 57% in the first quarter of 2002. EU imports have grown at a similar rate and reached 49.4% of total imports for 2001 and 50.3% for the first quarter of 2002.

The share of exports to the EU and CEFTA as a percentage of total exports grew from 55% in 2000 to 60% in 2001 and to 64% in the first quarter of 2002. The total turnover of Bulgaria with the EU and CEFTA countries reached 58% of the total foreign trade in 2001 and 60% in the first quarter of 2002. The turnover with EU and CEFTA reached 53% of GDP in 2001 and if the trends from the first quarter of 2002 are preserved, it will reach 55% of GDP by the end of this year without factoring the trade in services in the balance-of-payments current account. This relatively large share proves that the Bulgarian foreign trade has been effectively integrated into the markets of the EU current and future members.

The role of Bulgaria's trade with EU and CEFTA is far bigger if we set aside the imports of energy resources from Russia. The country's total turnover with EU and CEFTA in the area of consumer and investment goods is extremely high. Calculations including the subtraction of energy resource imports indicate that Bulgaria's turnover with EU and CEFTA constitutes 67% of the total trade in 2001 and 68% for the first quarter of 2002.

The process of Bulgaria's economic integration with the EU has deepened thanks also to the constant increase in foreign direct investment from the EU in Bulgaria. Bulgaria enjoys a higher-than-average relative share of foreign direct investment as percentage of GDP for 1998-2001 among the EU membership candidate countries. The share of EU-generated foreign investment dominates this high inflow of foreign investment and has been constantly on the rise. If in 1998 the share of EU direct investment constituted about 68% of the total amount of direct foreign investment, in 2001 it grew to 87%. As a result of the lasting upward trend in EU direct investment in Bulgaria, the whole period between 1992 and 2001 was characterized by a high relative share (about 77%) of EU investment in the total amount of foreign direct investment in Bulgaria. This powerful presence of European capital in the country is both an indicator and a guarantee for deepening integration of Bulgaria's economy into the EU.

The current relative share of trade with EU and EU direct investment fully corresponds with the criteria for integration with the EU. The high growth rates of trade integration guarantee further deepening and irreversibility of the process.

3.2.5. Share and significance of small and medium enterprises

Structural policy

The regulations governing the functioning of small and medium enterprises remained unchanged in 2001 and early 2002. The basic changes in the functioning regime of these enterprises has been triggered by the improved performance of the judicial system which considerably speeded up the registration of new firms and by the eased license and permit regimes which, in turn, made the establishment of a firm easier, faster and cheaper. The changes are beneficial mainly to sole proprietors and small entrepreneurs who have just entered the market.

Given the structure of the environment where small and medium enterprises operate the amendments to the Patent Tax Act had a negative effect because they increased the tax burden on micro enterprises. At the same time, by offering credit- and-guarantee schemes, both Bulgarian and foreign institutions create favorable conditions for an increased availability of bank credit to small and medium enterprises. The Small and Medium Enterprise Agency continued its activities. It has been improving its role as representative of the sector and as a consulting body for its members while seeking opportunities for project financing. The Agency has also developed its intermediating role by keeping a public register of small and medium enterprises as well as a register of small public procurement bids, which help small and medium enterprises be included in the mechanism of public procurement. The same period saw the increase in financial resources appropriated for small and medium-size enterprises and originating from EU-sponsored programs or from projects launched by EU-based financial institutions and managed by Bulgarian banks. The network of local agencies for regional development has expanded as a natural partner of small and medium enterprises.

Share and significance

According to data provided by the National Statistics Institute for 2000, small and medium enterprises in Bulgaria number 220,000 or 99% of all non-financial enterprises. They account for 50.5% of all jobs, thus preserving the lasting trend of a rise in that share up from 36.7% in 1996 and 44.0 % in 1998. Small and medium enterprises create 39.5% of the added value produced by non-financial enterprises. For the private sectors, these indicators amount to 65.9% and 42.4%, respectively.

Data about non-financial enterprise employment in Bulgaria indicate that the rise in employment in 2000 as compared to 1999 was generated exclusively by the small and medium enterprises (an increase by 80 000 jobs) which manage to compensate for the decline in large enterprise employment (a decline by 45 000 jobs) and demonstrate the significance of this sector for the alleviation of social problems related to the process of restructuring of the inherited uneconomic production facilities.

Latest figures for 2000 show that the sector of small and medium enterprises accounts for more than half of the jobs and creates a significant part of the added value in the non-financial sector. The dynamics of these indicators demonstrate that the sector of small and medium enterprises is viable and competitive in Bulgaria and will be of considerable importance to the overall economic dynamics of the country.

3.2.6. The Competitiveness of Bulgaria’s economy and the role of foreign investment

The price and trade liberalization, privatization and the limited redistribution role by the state led to positive changes in the economic structure. Notwithstanding the adverse international market situation, the export structure and the productivity indices point to positive changes in the competitiveness of the country’s economy. Consumer goods’ exports kept its extremely high growth rate following the introduction of the currency board in mid-1997. Above all, there was an increase in EU-oriented exports, with the negative effects on the trade balance having been concentrated mainly on resources and goods characterized by a low degree of reprocessing. Consumer goods’ exports kept their double-digit growth rate despite the unfavorable external environment. The share of consumer goods in total exports rose from 30% in 2000 to 33% in 2001 and to 36% in early 2002. The consumer-goods trade balance remained positive.

The rise in the real exchange rate of the Bulgarian Lev to the euro following the introduction of the currency board has been compensated by growth in productivity thus causing no negative effects. Exports to the EU and CEFTA have been increasing at a rate, which has outpaced that of trade with third countries. The inflation differential with the EU has, to a great extent, been the result of the changes in excise taxes and elimination VAT exemptions, which have statistically changed the real exchange rate indices but have not practical influence on export prices and economic competitiveness. If the real exchange rate is calculated on the basis of producer prices, which are unaffected by the changes in indirect taxes, then between mid-1997 (when the BGN was fixed) and March 2002, the rise in the real exchange rate was about 30% and approximately equaled the rise in productivity over the same period, calculated as gross added value to employment. IMF estimates show that since the beginning of 1998 the trend towards a 2.4% annual appreciation of the real effective exchange rate is linked primarily to the Balasa-Samuelson effect, i.e. the faster growth in productivity in the tradables sector. (IMF Country Report No 02/ 49, March 2002).

With the inflow of foreign investment into the country, the technological productivity has also been gradually rising though it remains unaccounted for in the current statistics. The total amount of foreign investment for the 1998-2001 period reached USD 3 billion and exceeded more than three times the respective amount for the previous four years. Bulgaria ranks third among the EU membership candidates with regard to the share of foreign investment in GDP and the annual indicator of 6% is far above the average of 4.9% for all candidate countries. 2001 saw some slow-down in the inflow of direct foreign investment due to the international economic crisis and the completion of major privatisation deals. The net inflow of foreign assets declined by 30% from USD 976 million in 2000 to USD 679 million in 2001. The volume of green-field investment remains stable, despite the adverse external environment.

The forthcoming privatization of the Bulgarian Tele-Communications Company and Tobacco Holding Bulgartabac as well as the negotiated investment projects in the energy sector are expected to produce an increase in the inflow of foreign direct investment by the end of 2002 and in 2003. Foreign capital dominates the private sector, especially in the area of banking services. Front-running in the branch is the investment made by *American Standard* in the production of kitchen and bathroom accessories. The American Standard plants in Bulgaria have a strong export orientation and Europe's best production capacities in the branch. They attracted investment in related activities and launched the procedures for the transfer of suppliers from other countries to Bulgaria. The rapid expansion of international retail networks has continued. The first stage of the construction of a big business centre in Sofia has been completed, financed by foreign investors. The U.S. energy companies AES and Entergy launched long-term projects to of some USD 1.5 billion on aggregate, which will be effectively invested over the next few years. The World Bank has highlighted a number of economic sectors having relative competitive advantages and which grew over the last years and attracted foreign investment: tourism, pharmaceuticals, textiles and clothing, wood-processing and agriculture.

The improvement of foreign trade indicators over the last few years when the country has already been functioning in the conditions of an effectively liberalized trade environment with the EU has produced the most convincing evidence for Bulgaria's ability to withstand the competitive pressure by the EU. The existence of a liberalized trade regime with the EU has been recognized in a number of consecutive reports by the European Commission and the EBRD and in such conditions Bulgaria has managed to retain one of the lowest current account deficits as compared to other EU candidates. The average annual current account deficit/GDP ratio for Bulgaria was 4.6% in the period 1998-2001 compared to an average of 5.6% for all EU candidates. One has to note that a significant part of the deficit has been due to the interest payments on the country's long-term foreign debt. The stability of the external sector has been additionally strengthened by the fact that Bulgaria was one of the few EU membership candidates to substantially reduce its foreign debt over the 1998-2201 period with a parallel considerable rise in foreign currency reserves. In the conditions of a *de facto* fully liberalized industrial-goods trading regime with the EU, Bulgaria has kept a relatively low current account deficit/GDP ratio of 6.5% in 2001. At the same time, Bulgaria's exports to the EU have grown by 27.3% over the same period, which proves that the country's exports are competitive on the EU markets. In the conditions of a slow-down in the economic growth of Bulgaria's key partners, the country has continued to increase the relative share of EU-oriented exports to 54.8% in 2001 and 57% in the first quarter of 2002. All these facts testify to the constantly rising competitiveness and capacity of the Bulgarian economy to withstand the pressure by EU market forces.

The positive structural changes in the economy, the high growth rate of foreign direct investment after 1997 and the positive changes in the trade indices have shown that the Bulgarian economy is able to withstand the competitive pressure in the medium term. Under the conditions of an effectively liberalized trade environment and in the absence of protective barriers to EU imports, the current account deficit for 1998-2001 is below the average for all EU membership candidates despite the inherited large share of interest payments (Table 2). The foreign investment inflow-to-GDP ratio is above the average for the same period and EU-oriented exports from Bulgaria have recorded a continuous and significant growth even under the conditions of a slow-down in the EU growth rates, which is indicative of the existence of an export-oriented sector characterized by a high degree of competitiveness on the European market.

4. Overall assessment of the compliance

Prices and the trade regime in Bulgaria have been liberalized in accordance with the norms of a functioning market economy. There are no serious barriers to Bulgarian market entry or exit. The legal system has the capacity to service the turnover of economic exchange though it still needs significant improvements, which are expected to raise the effectiveness of the functioning market economy. The financial sector whose functioning is already dominated by foreign banks and their affiliates has continued to develop in a stable fashion and to improve its capacity to direct savings to product-generating investment in the private sector with a simultaneous adherence to the sound standards of reasonable banking. There is a sustainable macroeconomic stability and a broad public consensus on the major directions of the economic policy. Over the medium- term period no serious dangers can be expected for a reversal of these trends in a direction that could prove adverse to the functioning of markets.

The process of recapitalization as well as the ongoing reforms in the education and healthcare sectors give us grounds to conclude that in the medium term these two factors will reach a Level that would be sufficient for Bulgaria to withstand the competitive pressure by EU market forces. The existence of strong competition driven by imported goods and the regulations limiting the role of monopolies represent a guarantee for the existence of a really competitive environment. The relative share of trade with the EU fully corresponds with the criteria for the existence of trade integration with the EU. In the conditions of an effectively liberalized trade environment and in the total absence of protective barriers to EU imports the current account deficit for the 1998-2001 period is below the average for the EU membership candidate countries. The foreign investment inflow/GDP ratio is above the average for the EU membership candidates and Bulgaria’s EU-oriented exports have registered a constant and significant growth even in the conditions of an EU economic growth slow-down. The considerable growth of direct foreign investment, including from EU countries, since 1997, together with the positive trends in trade indices, linked to the rising competitiveness, demonstrate that the economy is able to cope with the EU competitive pressures in the medium term.

The overall assessment of the fulfillment of the Copenhagen criteria shows that Bulgaria is a functioning market economy and Bulgaria’s ability to cope with the competitive pressures and EU market forces in the medium-term is definitely realistic.

Appendix 1

Comparative data and assessments

Table 1.Key Economic Indicators*

Percent

Country	GDP		*Investment*		Inflation		Budget /GDP		Unemployment	
	1998-2001	2001	1998-2001	2001	1998-2001	2001	1998-2001	2001	1998-2001	2001
Bulgaria	**3.9**	**4.0**	**16.5**	**16.0**	**6.2**	**4.8**	**-0.5**	**-0.9**	**15.8**	**17.3**
Estonia	4.2	5.4	4.0	17.2	4.9	4.3	-1.3	0.4	12.2	12.7
Latvi a	4.8	7.6	15.5	11.0	2.7	3.0	-2.5	-1.8	13.5	13.1
Lithuania	2.7	5.7	2.6	10.6	1.5	2.0	-4.7	-1.7	15.0	17.0
Poland	3.5	1.1	3.4	-10.2	7.6	3.6	-4.0	-6.0	14.0	17.3
Romania	-0.4	5.3	-2.8	6.6	41.6	30.2	-3.9	-3.5	10.3	8.6
Slovakia	2.9	3.3	0.8	11.6	8.7	6.5	-4.0	-3.9	18.1	19.8
Slovenia	4.2	3.0	7.2	-1.9	7.6	7.0	-1.2	-1.2	7.0	5.9
Hungary	4.5	3.8	7.5	3.1	9.6	6.8	-3.7	-3.3	9.4	8.4
Czech Republic	1.0	3.6	1.7	7.0	4.4	4.1	-4.0	-5.7	8.7	8.9
Average	**3.1**	**4.3**	**5.6**	**7.1**	**9.5**	**7.2**	**-3.0**	**-2.8**	**12.4**	**12.9**

Source: *EBRD Transition report, update 2002; ?uropean Commission, European Economy, Enlargement Papers, April 2002.*

** The data for 1998-2001 represent annual average changes or values for the period; inflation and unemployment is end-of-period.*

Table 2. External Sector Indicators *

Percent of GDP

Country	Current Account Deficit		Gross foreign debt		Foreign Direct Investment	
	1998-2001	2001	1998-2001	2001	1998-2001	2001
Bulgaria	**-4.6**	**-6.5**	**82.1**	**75.7**	**6.0**	**4.9**
Estonia	-6.7	-6.5	58.0	60.9	7.1	6.4
Latvia	-9.4	-10.0	61.3	70.9	4.5	2.6
Lithuania	-8.8	-5.8	41.1	43.8	5.0	3.8
Poland	-5.5	-3.9	40.4	38.9	4.0	3.6
Romania	-5.1	-6.1	27.2	30.5	3.4	3.0
Slovakia	-7.0	-8.9	55.6	56.9	5.9	7.4
Slovenia	-2.1	-0.4	30.5	35.7	1.2	2.0
Hungary	-3.6	-2.3	62.8	69.0	3.4	4.3
The Czech Republic	-3.6	-4.7	41.1	39.0	8.8	8.5
Average	**-5.6**	**-5.5**	**50.0**	**52.1**	**4.9**	**4.7**

Source: *EBRD Transition report, update 2002.*

**The data for 1998-2001 represent annual averages for the period.*

Table 3. Assessment of Trade Legislation and Its Effective Implementation *

	Legislation	Effective Implementation	Total
Czech Republic	3	3+	3+
Estonia	4-	3+	4-
Hungary	4	4-	4-
Latvia	4	4-	4-
Lithuania	4	3+	4-
Poland	4-	4	4-
Slovakia	3	3	3
Slovenia	4	4-	4
Bulgaria	4	4-	4-
Romania	4-	3+	4-
Bulgaria's Standing (1 to 10)	**1-5**	**2-5**	**1-5**
Bulgaria's Standing within the Helsinki Group (1 ?? 5)	**1-3**	**1-2**	**1-2**

Source: *EBRD- Transition Report 2001*

**Scale ranges from 1 (minimum) to 4+ (maximum)*

Table 4. Overall Assessment of the Financial Sector development In Bulgaria in 2001 as compared to other countries *

Country	Banking reform and Interest Rate Liberalization	Capital Markets and non-bank financial institutions
Bulgaria	3	2
Estonia	4-	3
Hungary	4	4-
Latvia	3+	2+
Lithuania	3	3
Poland	3+	4-
Romania	3-	2
Slovakia	3+	2+
Slovenia	3+	2+
Czech Republic	4-	3
Bulgaria's Standing (1-10)	**8-9**	**9-10**
Bulgaria's Standing within the Helsinki Group (1-5)	**3-4**	**4-5**

Source: *Transition Report 2001, EBRD;*

**Scale ranges from 1(minimum) to 4+(maximum)*

About the European Institute

The EUROPEAN INSTITUTE (EI) was founded by Stanislav Daskalov and Nickolay Mladenov in April 1999 in response to Bulgaria's increased efforts at speeding up the process of preparing for European Union (EU) accession.

EU Accession is an overarching priority for Bulgaria and demands the concerted efforts of government and non-governmental organisations alike.

The EUROPEAN INSTITUTE is a private, non-political, non-profit, non-governmental organization which mission is to support the efforts of governmental and non-governmental agencies to successfully prepare Bulgaria for EU membership through research, technical assistance, training and public awareness initiatives.

EI has four main areas of activity:

? *policy research* – focusing on wider policy areas related to EU accession and the enlargement process in general;

? *technical assistance* – providing in-house or external (local and international) consultations to different government and non-government stakeholders on specific policy issues related to the accession process;

? *public awareness* – implementing projects that contribute to stimulating public debate about EU enlargement and informing stakeholders about the costs and benefits of accession.

? *training and exchange of experience* – improving the competencies of different institutions and professional groups in the areas of European integration, pre-accession and structural funds as well as exchange of negotiation experience between accession and association countries.

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